

MOSCOW Financial Weekly

For the week ending February 21, 2003
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Government to review revised banking strategy; heavy state presence to continue
- CBR considers mortgage-backed bonds
- Foreign investment up 38.7% in 2002; FDI remains unchanged

Key Economic Indicators

| Indicators | Level | % chg 1 week | % chg since Jan. 1 |
|-------------------------|------------|--------------|--------------------|
| Ruble/\$ (MICEX) UTS | R31.5500 | -0.29 | -0.74 |
| Monetary Base* | R901.3 bln | 1.65% | -4.15** |
| CPI | NA | NA | 3.13 |
| International Reserves* | \$51.4 bln | 0.50 | 7.76 |
| RTS Index (end of week) | 373.88 | 0.80 | 4.12% |
| Refinancing rate | 18 | 0 | -3 |

*For week prior

** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

According to Goskomstat, **industrial production increased by 4.9%** y-o-y in January. Ferrous metals (13%) and the fuel industry (9.4%) contributed substantially to this figure. Non-ferrous metals production increased by 15.1% after falling for almost half a year, but this sector has an uncertain future in light of current world overproduction, which leads to higher inventories and lower prices. These industries, primarily oriented toward the external market, together accounted for 75% of January's industrial growth figure. However, growth in production for domestic-demand industries continues to be modest - the food industry was up by 3.3%, for example, while light industry and machinery industries were down by 1.9% and 3.2% respectively.

Foreign investment increased by 38.7% y-o-y in 2002, for a total of \$19.78 billion. The breakdown is as follows: Foreign direct investment (FDI) was almost unchanged, increasing only 0.6% (\$4 billion in total); portfolio investment was up by 4.6% (\$472 million); and the "other investment" category was up by 55.8% (\$15.31 billion). While FDI is considered to be a fair predictor of economic growth, in Russia's case the correlation has not been so strong. FDI contracted during the first half of 2002, increasing only in the third quarter of the year. The fourth quarter brought \$1.37 billion in FDI -- 1.8 times higher than in the same period of 2001. This may indicate that a number of foreign investors, as co-owners of Russian companies, have expanded beyond

providing credit to Russian companies and are now adding to their total capital, reflecting investors' lengthened time horizon. The "other investments" category increased by 55.8%. Most investments in this category consist of non-trade credits, i.e. credits from foreigners to companies to which they own less than 10%. This source remains very important, both because credit from Russian banks is still not readily available, and because borrowing became more attractive, following the abolishment of the tax benefit on FDI investment and lower interest rates abroad. Germany surpassed the U.S. this year for first place foreign investor (19% of the total investments), Cyprus came in second (13.1%) and the US third (12.9%).

Banking sector

The Finance Ministry submitted a revised draft of its joint with the CBR **banking strategy** to the GOR for approval. According to leaks in the press, the document says that by the beginning of 2007 the ratio of combined banking assets to GDP will rise from the current 37.6% to 44-45%; the ratio of banking capital to GDP - from 5.4% to 6-7%; and the ratio of loans to the real sector to GDP - from 15.1% to 19-20%. This is considered to be not enough ambitious by most commentators.

Anton Siluanov, Head of Macroeconomic Policy and Banking Department at MinFin, said in an interview that the state for now would retain its presence in two universal banks, **VTB** and **Sberbank**, and four agent banks: Russian Development Bank, Russian Agricultural Bank (Rosselkhozbank), Roseximbank and VEB. However, he noted that by 2005-07 the state would own less than 50% in VTB (as required by EBRD going to by a 20% stake in the bank), but reducing the CBR's share in Sberbank is not on the agenda at all.

The process of restructuring **CBR's government securities** portfolio is completed. The CBR announced that it has exchanged with Minfin R300 billion worth of fixed coupon bonds from its portfolio for 14 new issues worth R282.5 billion at face value but with higher interest. The CBR plans to use R32.4 billion worth of bonds for open market operations and the rest may be used for reverse repo operations when needed.

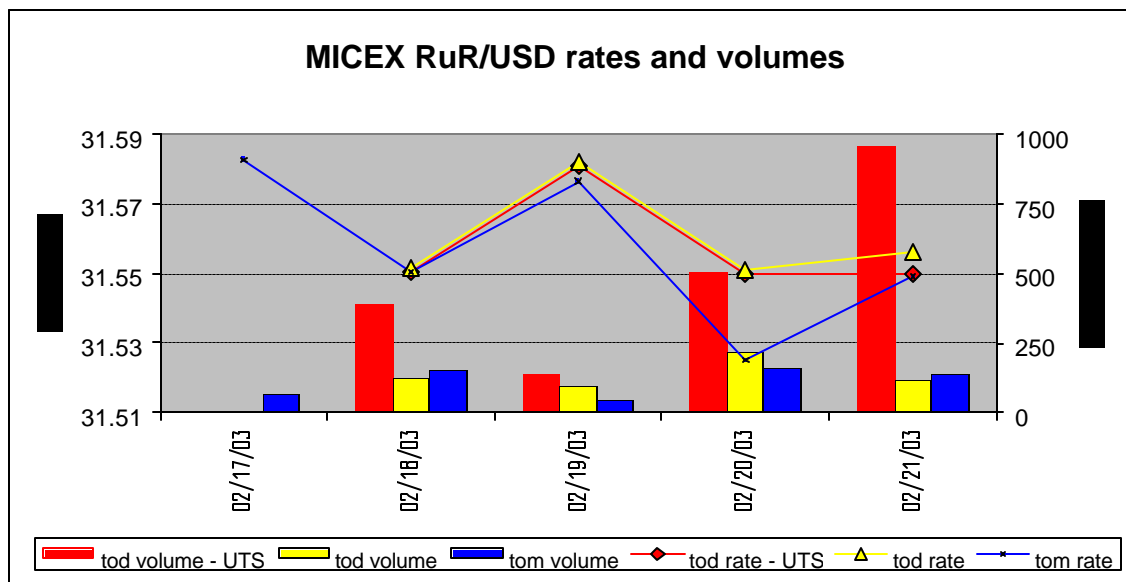
Vneshtorgbank's total assets increased over 2002 from R186.1 billion to R234.4 billion as of January 1, 2003. Net profit in 2002 was R9.3 billion, net assets reached R179.4 billion. VTB's equity at the beginning of this year was equal to R58.7 billion, while its authorized capital is R42.1 billion. The bank published this data for the presentation of its third ruble bond issue.

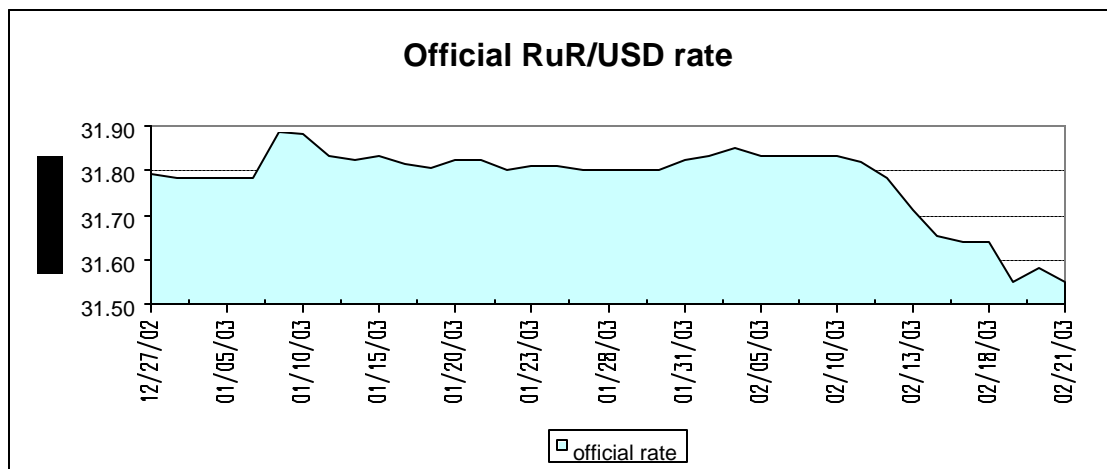
Banks may be allowed to issue **mortgage-backed bonds** and launch a secondary market for such securities. The CBR is considering the issue, Andrei Kozlov, First Deputy Chairman said. Once a positive decision is made, the CBR would have to amend some regulations related to risk assessment as well as bank accounting rules. Kozlov also said that the bill on mortgage securities submitted by Duma members also provides for issuance of mortgage certificates similar to shares in unit investment (mutual) funds.

Financial markets**Forex Market**

On Monday, dollars with same-day delivery were not traded because of the banking holiday observed in the U.S., but the "tom" dollar fell sharply against the ruble at MICEX. The dollar's slide continued the next morning but was stopped at R31.55/\$ by CBR intervention. On Wednesday the dollar suddenly firmed even without visible help from the CBR, but on Thursday it went down again. The CBR went on buying at the same price, R31.55/\$, both in MICEX sessions as well as in the interbank market through the rest of the week. Nevertheless, on both Thursday and Friday afternoons the dollar was priced in the interbank below the level at which the CBR was defending it, and "tom" prices at MICEX fell below it too. These two days only, the CBR bought about \$2 billion and a new record was set in Friday UTS: trade volume reached \$956.52 million.

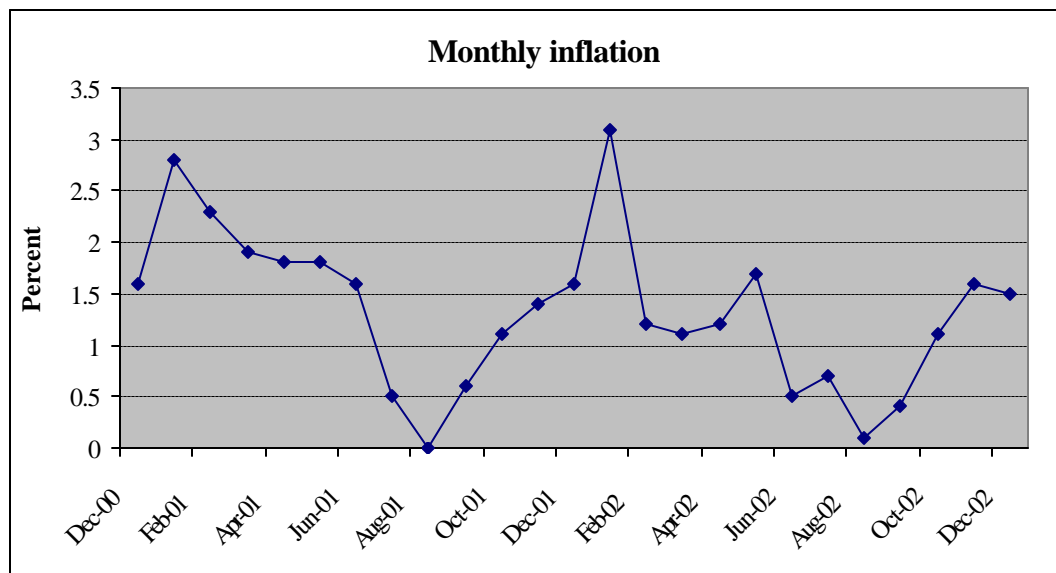
For the week the dollar weakened 0.29%, closing in the UTS on Friday at R31.5500/\$. MICEX weekly trade volumes surged to \$1989.86 million, \$559.21 million and \$575.88 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.





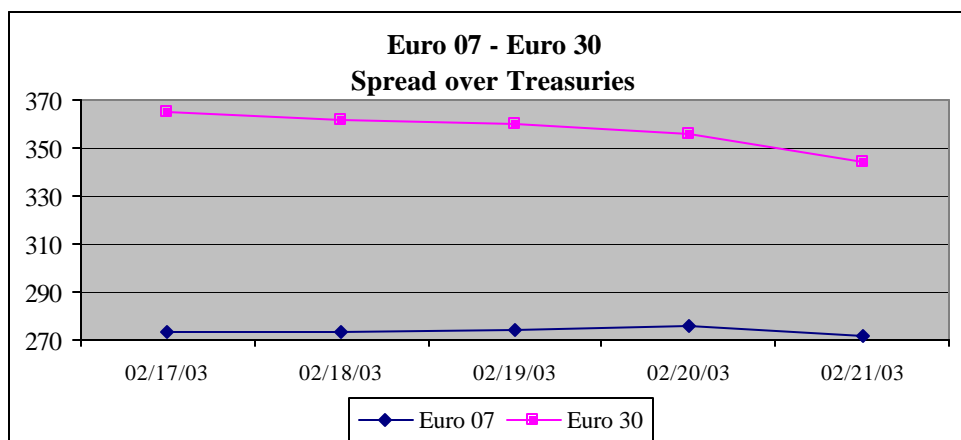
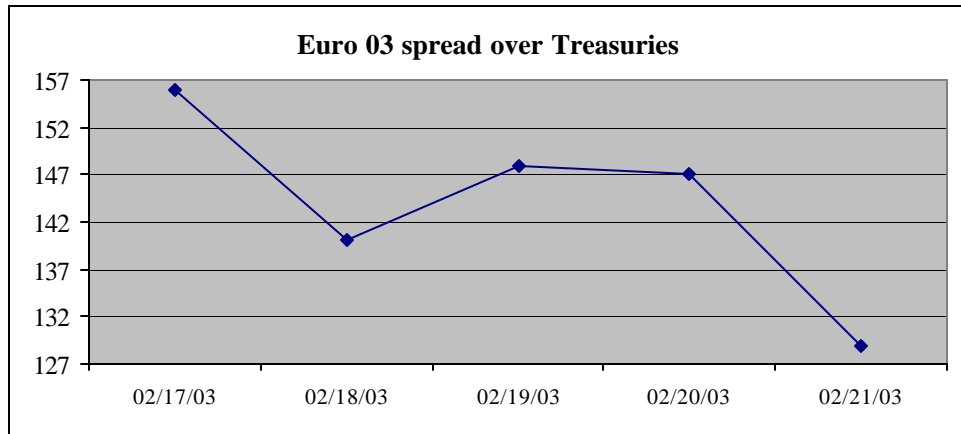
Prices

According to the First Deputy Minister of Economy, prices were up by 0.7% during the first 10 days of February. First Deputy Finance Minister Aleksei Ulyukaev estimated inflation to drop below 2% in February, explaining high inflation in January (2.4%) by the increased money supply as well as budget spending at the end of the year. Since the beginning of the year the prices are up by 3.13%.



Eurobonds

The Russian Eurobond market has been hitting records last week again on the positive news about the huge over-subscription on Gazprom Eurobonds. The spread of the most liquid Russian Eurobonds, Euro-3 has been falling throughout the week and the yield on the paper is already very close to 8%, which could become the next market target.



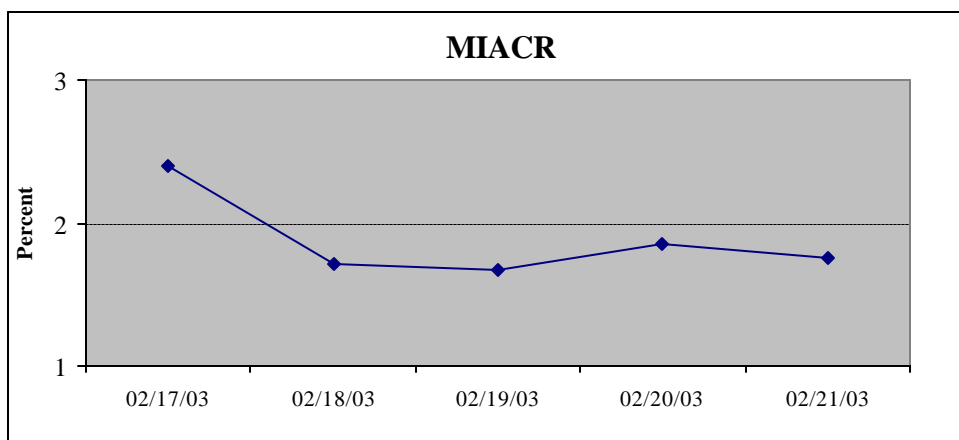
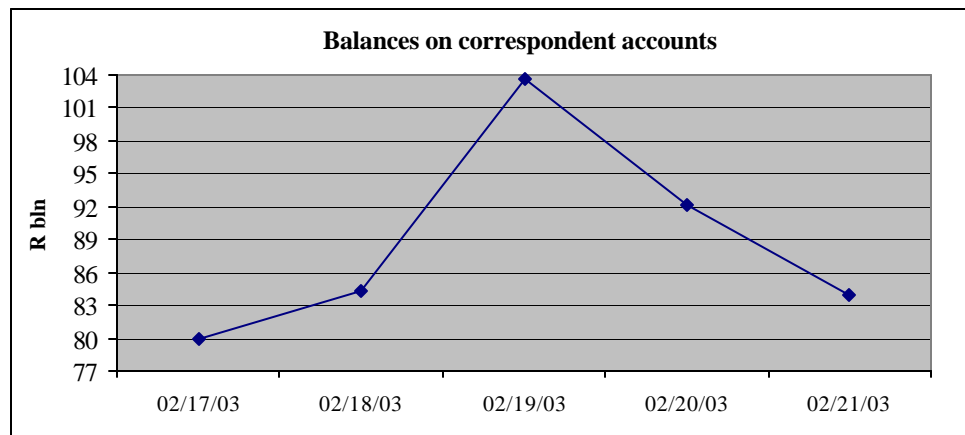
Interest/Bond Market

Bonds/Bills

The secondary OFZ/GKO market continued to rally last week, hitting new record highs. For the first time ever, yields on all issues went down to the single-digit level. Increased ruble liquidity as well as continuing U.S. dollar depreciation supported the market last week. By the end of the week, prices went slightly down as a result of profit fixing after a week of very strong growth.

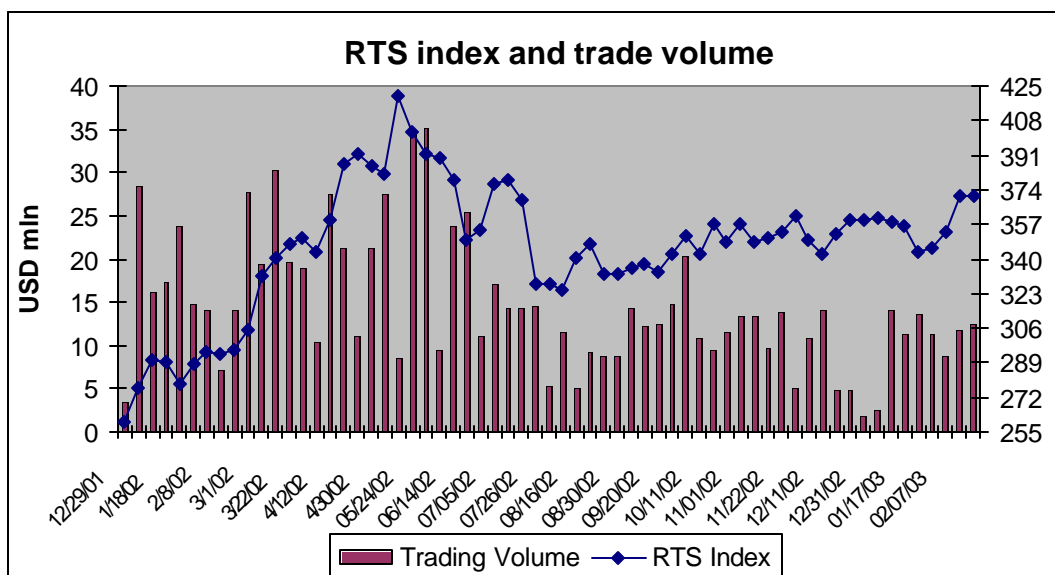
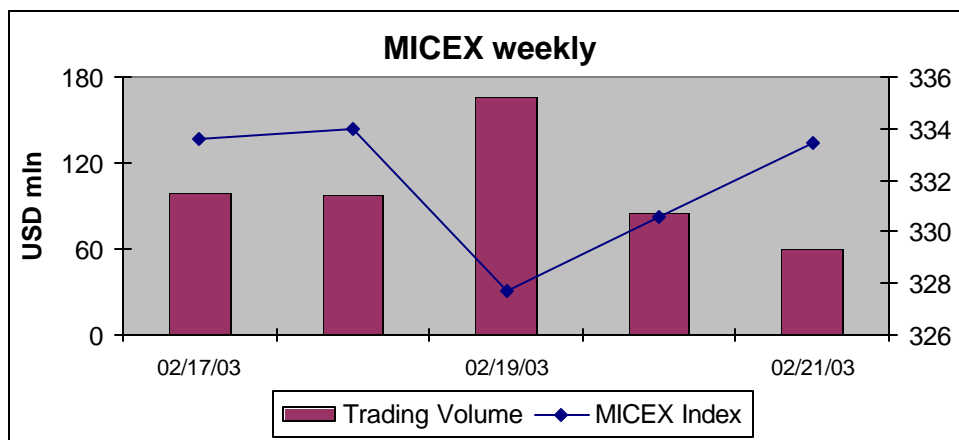
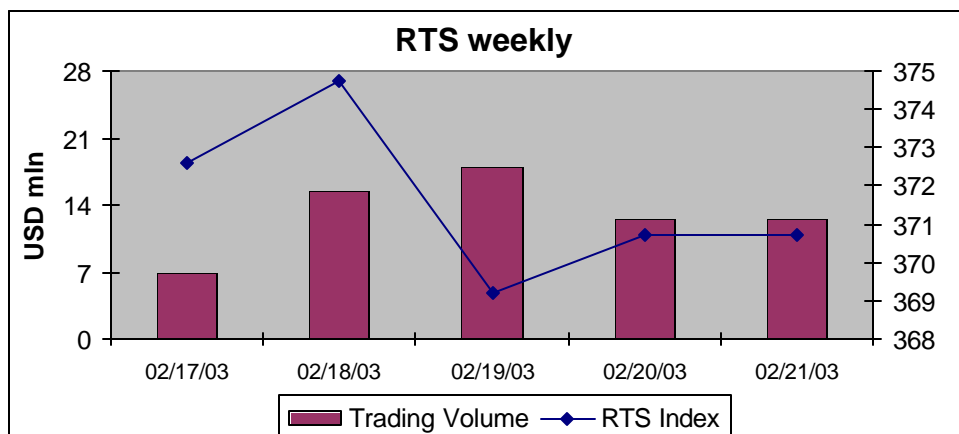
Overnight rates

There were no ruble shortages on the balances on banks' correspondent accounts at the CBR last week. Balances fluctuated at above average levels all week, while the overnight rates were down at 1.67-2.4 p.a. (MIACR) which is quite a low level.



Stock Market

The stock market had no clear-cut trend last week, fluctuating instead in the narrow range of 370-375 points. The market grew slightly during the first two sessions, but the increase was not supported by strong volumes. The liquidity of the market was low due to low activity in London as well as a holiday in the States. On Wednesday, players preferred to take profits on the wave of negative news from world stock markets as well as falling oil futures prices. Over the next two days, the market rose, but many players stayed on the sidelines - some didn't want to open positions before the long weekend, some didn't want to close due to the rather neutral tone of news, which didn't necessarily foretell a decline in prices. RAO UES was dragged slightly down after the news on the bill passage in the Duma, which was an expected profit fixing. The RTS index was up by 0.8% for the week in dollar terms.

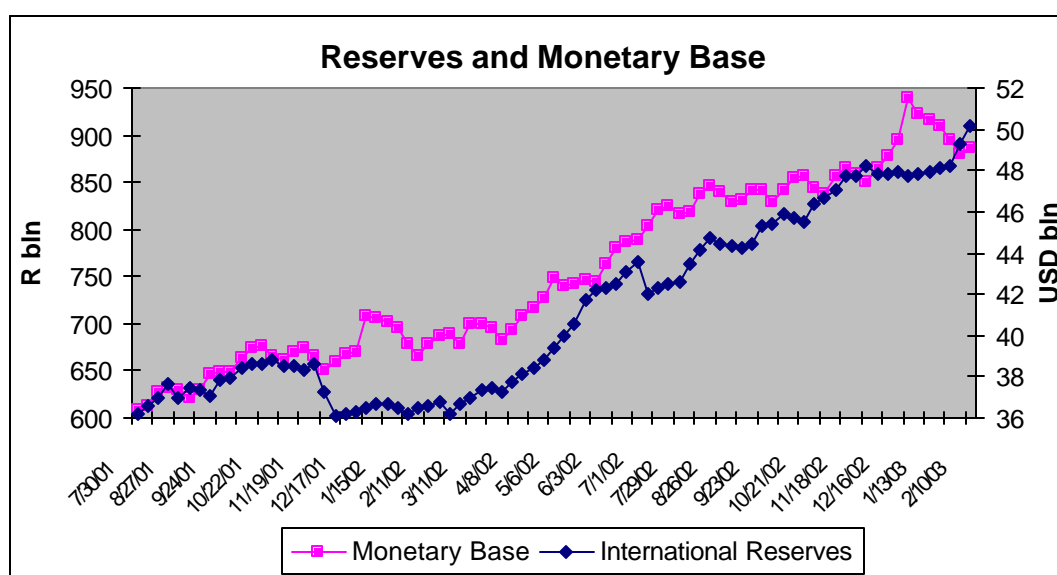


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International Reserves and Monetary Base

The international reserves of the CBR continued to build, ending the week of February 14 at \$51.4 billion. The growth is due to continued high oil prices. Last week oil prices continued to grow, reaching a 29-month high and promising further increases in reserves. The CBR had to abandon its annual forecast of \$55 billion, while many market participants estimate the end-of-year reserves to be \$60 billion or above. Russia now ranks among the top 15 countries in the world with the highest foreign exchange reserves.

The monetary base grew again last week and stopped at R901.3 billion level, 1.65% higher than a week before and still 4.15% lower than in the beginning of the year.



EXPLANATORY NOTES

1. EXCHANGE RATES: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS fix (rounded) becomes the "official" ruble rate for the next day. "\$-tod" price is the price of the dollar with same day delivery. "\$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is \$100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. LOMBARD CREDITS, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.